Industrial Bonds

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Industrial Bonds Before 1900

THE industrial corporation bond is a purely modern product. Thirty years ago, although there were then in existence a large number of substantial industrial corporations of large capital and with numerous stockholders, industrial bond issues were practically unknown. Twenty years ago, even though by that time the period of the formation of gigantic industrial trusts had fully arrived, the industrial bond issue was a novelty and but few corporations had resorted to this type of financing. Not until within the last decade have industrial bonds taken their place as an important representative type of investment security.

It is true that long before 1900 a large number of short term obligations and note issues had been floated by certain types of industrial companies; but such flotations were almost invariably made in response to urgent needs for temporary financing rather than for the purpose of securing permanent capital. If any one will glance over the voluminous statistical records of industrial bond issues which are listed on the various American exchanges today, or examine the records of unlisted issues, he will be immediately impressed with the small percentage of issues which date back to any year prior to 1900. After 1900, however, the output of this form of security tended to increase rather steadily, and since 1910 this method of raising permanent capital has become commonplace.

There is a reason for everything, and the reasons why industrial bonds did not appear in quantity prior to 1900, and began to appear with increasing frequency after that year, are easily stated. During the earlier period, the industrial enterprises of the country had not, as a general rule, assumed the large corporate form. We had our old style "trusts," such as the Standard Oil Trust, the Sugar Trust and the Whiskey Trust, but these were not corporations in the modern sense, but simply alliances of one form or another, invented for the purpose of regulating prices, restraining trade or throttling competition. They were not formed for the purpose of raising large amounts of capital or for consolidating single industries under one corporate head. With a few important exceptions, the industrial corporations of that decade were relatively small, and their securities were not known or held by any wide circle of investors. Even those of comparative importance were "close" corporations, like the Carnegie Steel Company, or else could boast of not more than a few hundred stockholders at the most. Not until 1897 or 1898 did any number of industrial securities appear on the New York Stock Exchange or the New York outside markets, aside from the original type of industrial "trust." However, there were not many of the latter.

Thus the industrial corporation as

we know it today was practically non-existent at that time. Its securities were, in most cases, looked upon as speculations rather than investments and where capital was needed the speculator rather than the investor had to be appealed to. Consequently, any corporation of an industrial character which attempted to borrow capital by means of bond issues was apt to be looked upon with suspicion. The investor would not buy industrial bonds because of their apparent speculative character, while the speculator did not like them because of the limitation of speculative possibilities.

When the great industrial consolidation movement set in at the close of the century, and hundreds of plants of small concerns in numerous lines of industry were being merged into great corporate units, it became necessary to appeal largely to the speculator for the financing of these consolidations. A period of broad speculative activity was under way all over the country. We had come through the depression of 1893–96; we had completed the reorganization of all the broken down railroad systems; the free-silver craze had spent itself, and the country was securely lodged on the gold basis. Industry was reviving and wages rising all over the country. A stock market boom had set in in Wall Street in 1898, after the Spanish War, and was not again seriously interrupted until the end of 1902.

This period was ideal for the flotation of speculative enterprises and, while money was cheap, and pure investment conditions were favorable, the average investor was being fully supplied with a wide range of selections in the railroad bond market and was not an apt pupil for the industrial financier. Those were the days when St. Paul general 4s at 110 looked cheap and when men bid large premiums for $3\frac{1}{2}$ per cent long term railroad bonds. Illinois Central 3s then sold around par and the prediction was freely made that within another decade all the great American railroads of high credit would be doing their financing on a $2\frac{1}{2}$ to 3 per cent basis.

Thus industrial companies of even the highest credit had little chance of securing pure investment capital at such a time; but there were vast possibilities in appealing to the speculator and the speculative investor. Consequently, nearly all of the great industrial consolidations were financed through the issuing of large amounts of preferred and common stock. The preferred stock offered generally had a 7 per cent dividend and asset preference, and was offered at par with a substantial bonus in common stock. The preferred issue was supposed to represent the asset value of the plants merged, including necessary new working capital, while the common stock generally represented a capitalization of the expected increases in earning power under concentrated control. All of the important consolidations were financed in this way. Few, if any, bond issues were created. In some cases, however, old bond issues were assumed, but these were few and far between.

INDUSTRIAL SECURITIES AFTER 1902

After 1902 or 1903 this condition in the industrial security field began to change. Many of the consolidations of the earlier period had not been successes; the expected increases in

profits had not been realized, and all too soon a very large number of companies found themselves without sufficient working capital. The consolidations had all been formed in a boom period and for the most part on a wasteful and extravagant basis. Many an enterprise with great intrinsic strength, so far as its type of business was concerned, faced disaster simply because of an urgent need for funds. It was usually impossible to raise further funds through the issue of stock, either common or preferred. In most cases the market prices of the stocks had severely declined, and, as the speculative mania had collapsed in Wall Street, the big industrial companies found it absolutely necessary to make a direct appeal to the genuine investor. The only way to secure funds from the investor in any substantial amount was to offer him some type of security of undoubted strength and value. An industrial bond, secured on the assets of the company, with full priority over the claims of the stockholders, both common and preferred, was the only kind of investment that the conservative man would consider at that time.

Consequently, industrial bond issues began to appear in increasing numbers. The United States Steel Corporation put through its bond conversion scheme, whereby a large amount of its preferred stock was retired and its second mortgage bonds issued; other steel and iron companies, manufacturing concerns of various types and many of the representative consolidations of a few years before soon had bond issues outstanding. Many a large industrial corporation was in those days saved from receivership or disintegration through the timely flotation of a bond issue and in after years developed into a position of permanent security and strength.

Thus the industrial bond, like most other particular types of investment securities, was mainly the outgrowth of an emergency. Had the original plan for financing and building up industrial combinations been an unqualified success, the industrial bond, as we know it today, might not have come widely into vogue for many years, if at all. But after 1905, and up to recent times, the industrial bond was steadily breaking down prejudice and enlarging its investment market in this country. Fifteen years ago the typical investor almost invariably ruled out an industrial bond investment, simply because it was an "industrial" and, therefore, must be speculative. Ten years ago, as a result of so many of this type of bond having become seasoned and having proven themselves good, the prejudice had been largely broken down; while during the past five years, the average intelligent investor no longer discriminated against industrials, but in his selection was willing to put them all to the regular investment tests which he would accord other types of securities.

INDUSTRIAL BONDS TODAY

Through this evolution in financial affairs and the accompanying seasoning process, the industrial bond investment has now come into its own. Today the investor has a wide range of choice in the industrial bond field and can select issues of fully as high quality as in the steam railroad or other fields. He can also secure fully as large an income return as in other

directions and in many instances can find really greater bargains.

Industrial bonds of all qualities and grades and of varying characteristics can be found. In these respects they do not differ from other types of bonds; there are issues which appeal to speculator as well as investor; the man who wants an income but also "a chance at a possible profit" can find it in the industrial bond market today as easily as he can find it in the public utility or steam railroad bond market. Industrial bonds are not so plentiful as railroad bonds, but bargains are sometimes far more plentiful. This has proven to be the case to a very large degree during the past half dozen years. While the highest grade long term industrial bonds have receded in price since 1914 in the same way that the highest grade railroad bonds have, yet junior grade industrial bonds have held far better, on the average, than have junior grade railroad bonds during the past few years.

Railroad Bonds

There have been special reasons, of course, for the great decline which has taken place in railroad bonds since the opening of the World War. The enormous amount of foreign liquidation in the old seasoned issues, which were held so largely abroad, the abnormal war-time conditions which tended to injure the position of the railroads as a whole, and the uncertainty regarding the future of the railroads after their return to private operation, have naturally caused depression of a most extreme character in this type of security. Added to this has been the prevailing tendency, long continued, toward high money rates, the competition of mammoth war loans and the depressing effects of high war taxes. These latter factors have depressed industrial bonds also, but, generally, not to the same extent. Industrial bonds have not gone down alarmingly, on the average, for two reasons: First, they were not, as a rule, selling at such high average prices at the opening of the war as were similarly strong or secure railroad bonds; second, industrial companies have been benefited, in a large number of cases, by the same abnormal war-time conditions that have so seriously injured the railroads.

Simplicity of Industrial Bonds

While several different types of industrial bonds are familiar to every market, there is not the wide diversity of type that will be found in the railroad field. In the railroad field one will find mortgage bonds, running from first mortgage to eighth or tenth mortgage; consolidated, collateral, refunding, general, general consolidated, general lien, prior lien, debenture, income and many other types of bonds. Some of these issues will be directly secured; some indirectly. A first mortgage railroad bond may be secured on a worthless branch and be less secure than a tenth mortgage on the same company's main line; a consolidated general lien on a railroad may be better than all of the so-called underlying liens on the same property. But not so, as a rule, with the industrial bond. It is generally greatly superior to the railroad bond in simplicity. Usually it is the single bond obligation of the company, and very seldom do we find an industrial company with more than three or four bond issues out-

standing; while a vast number of industrial companies have no bonded debts whatever. A notable exception is the United States Steel Corporation, but even this company has outstanding only two bond issues of its own, all of the others having been assumed either at the time of the merger twenty years ago or since.

I have already pointed out the reasons for the scarcity of industrial bond issues as compared with railroads. The industrial corporation was originally formed and financed through stock issues alone, while the great railroad companies are all earlier consolidations of companies which for generations had been financed almost exclusively through the issue of bonds. Thus a typical railroad like the Erie has outstanding and is responsible for fifty or sixty different bond issues, whereas a typical industrial company like the American Smelting & Refining Company has but one.

In earlier days industrial companies frequently issued debenture bonds rather than mortgages. This was a natural outgrowth from the custom of issuing notes or financing with temporary loans and commercial paper. In many cases the earlier industrial companies found it impossible to place actual mortgages on their properties. Their charters, framed at the time they were first formed through the flotation of stocks often forbid the placing of any mortgages on the properties without the consent of a large majority of the stockholders. But gradually it was realized that a mortgage bond giving the company necessary funds and good credit would in the long run benefit the stockholder, while it could hardly be more harmful for him than a debenture bond or note which would in any event have a legal claim ahead of the stockholder on both the assets and income. In fact, from any point of view, a long-term bond obligation furnishing permanent capital, is bound to be better for the stockholder than temporary obligations or floating debt.

SECURITY OF INDUSTRIAL BONDS

With a full recognition of these facts, industrial mortgage bonds have come more and more into vogue in recent years, and most new industrial bond issues nowadays are secured in one form or another. They have also gradually taken on the characteristics of other types of railroad bonds. In recent years, convertible industrial bonds frequently have come into the markets, as have collateral bonds, secured by pledge of other securities, assumed or guaranteed industrial bonds, etc. These different types of issues have been created, of course, in response to investment market conditions. The industrial convertible bond, like the old railroad convertible issue, is chosen to appeal to the man who wishes to both invest and speculate, but wants to be sure that his speculation is all in one direction. In other words, he wants to make his principal and income secure, but also wants to share in any possible appreciation that may occur in the price of the stock into which the bond is convertible. This type of bond is often issued by companies whose credit is not of the highest, or was not at the time the bond was issued.

Convertible Bonds

There have occurred many instances of large profits resulting from invest-

ment in industrial convertible bonds, a notable case being that of the Pierce Oil Corporation 6s, recently called. These bonds were selling below 75 in 1916, but early in 1919, as a result of a rise in the stock, they sold well above 130. The Otis Elevator 5s which used to sell around 80 have recently risen to 140. The Chile Copper Company has also done financing with convertible bonds, as have Wilson & Co., Armour & Co. and the Bethlehem Steel Corporation. In some cases the convertible bonds are convertible into other issues; in some cases into preferred as well as common stock, etc.

But while convertible bonds are often attractive enough as real investments, they are generally in a more speculative position than the representative industrial bond investment. The convertible feature is what usually makes them attractive, and not their intrinsic quality.

In judging industrial bonds, the investor naturally should exercise extreme caution. Ordinarily, it is more difficult to ascertain the real investment value of an industrial bond than of a railroad bond. Railroad reports are necessarily more elaborate and detailed than industrial reports. Uniformity is required by law and there is little excuse for an investor to go wrong on railroad *information,* although of course he may easily go wrong on deductions or opinion. But in the case of the industrial company an investor is often asked to take a great deal on faith. Many companies furnish full information and the reports of some are notably elaborate and complete, but there are far too many who fail to furnish the essential facts. In such cases the investor must do the best he can with what is available and if he is not satisfied he should reject the investment.

It is difficult to compare the relative value of industrial bonds, for the reason that as a class they represent many businesses of distinct or diversified character. One can, of course, readily arrive at the asset value back of a bond of the United States Steel Corporation, the great assets of which are exhibited to any and everybody, but a bond secured on a business the main asset of which is a trademark, may or may not be good. Earning power of such a business is important of course; but earning power alone considered may easily lead an investor to disaster. The earning power of the great H. B. Claflin Company was always heavy, but the absence of a complete exhibit of liabilities in its annual reports resulted in enormous losses to its stockholders.

The safest plan for every investor, in selecting industrial bonds, is to confine himself to obligations of those companies who follow the custom of taking the public into their confidence and exhibiting all the facts as they actually are. More and more managements are doing this every year and the time should not be far distant when every industrial enterprise which seeks capital in the investment world will adopt this enlightened policy.